

# AOL Time Warner

Steven Teplitz  
Vice President and  
Associate General Counsel

May 20, 2003

## Via Hand Delivery

Marlene H. Dortch, Secretary  
Federal Communications Commission  
Office of the Secretary  
c/o Vistronix, Inc.  
236 Massachusetts Avenue, N.E.  
Suite 110  
Washington, DC 20002

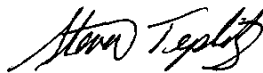
Re: CS Docket No. 00-30

Dear Ms. Dortch:

Attached please find an original plus four copies of AOL Time Warner Inc.'s Reply to comments submitted in response to its Petition for relief from the condition restricting AOL Time Warner's provision of streaming video advanced Instant Messaging high speed services via AOL Time Warner broadband facilities.<sup>1</sup>

Please do not hesitate to contact me if you have any questions regarding the foregoing.

Respectfully submitted,



Steven N. Teplitz

cc: Chairman Michael K. Powell  
Commissioner Kathleen Q. Abernathy  
Commissioner Jonathan S. Adelstein  
Commissioner Michael J. Copps  
Commissioner Kevin J. Martin

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<sup>1</sup> *In the Matter of Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations by Time Warner Inc. and America Online, Inc., Transferors, to AOL Time Warner Inc., Transferee*, 16 FCC Red 6547 (2001) ("Order").

Susan Eid  
Stačy Robinson  
Johanna Mikes  
Jordan Goldstein  
Sam Feder  
W. Kenneth Ferree  
Deborah Kline  
Royce Sherlock  
John Rogovin  
James Bird  
Qualex International

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, DC 20554

In the Matter of:	)	
	)	
Applications for Consent to the Transfer	)	
of Control of Licenses and Section 214	)	CS Docket No. 00-30
Authorizations by Time Warner Inc. and	)	
America Online, Inc. Transferors, to	)	
AOL Time Warner Inc., Transferee	)	

**REPLY**

AOL Time Warner Inc. ("AOL Time Warner"), pursuant to the procedures established by the Federal Communications Commission ("Commission"), hereby submits its reply comments in the above-captioned proceeding.<sup>1</sup> On April 2, 2003, AOL Time Warner filed a Petition for the removal of the condition that restricts its ability to offer Internet users streaming video advanced Instant Messaging-based high-speed services ("AIHS") via AOL Time Warner broadband facilities (the "Condition"). The Petition explained how circumstances have changed materially since the Condition was imposed and why there is no factual, legal or economic basis upon which to conclude that AOL is "dominant" in Instant Messaging ("IM")<sup>2</sup> today.

As the Petition made clear, there is no factual basis for continued imposition of the Condition. Since the *Order* was adopted two and a half years ago, IM services have continued to

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<sup>1</sup> *In the Matter of Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations by Time Warner Inc. and America Online, Inc., Transferors, to AOL Time Warner Inc., Transferee*, 16 FCC Rcd 6547 (2001) ("*Order*").

<sup>2</sup> As explained in the Petition, "IM" is a term used to describe Internet-based services that provide consumers with the ability to exchange short text messages that appear virtually instantaneously on each other's screen. While similar in many respects to e-mail, IM incorporates a number of additional enhanced features that make it possible to, among other things, maintain a list of online correspondents and monitor their online status.

develop rapidly and become more competitive. Significantly, AOL's "share" of IM users has declined while its competitors' shares have grown. As recently as June 1999, AOL's share of text-based IM was virtually 100%. Today, AOL faces stiff competition from Microsoft, Yahoo! and a number of other smaller IM providers. Long term trends demonstrate healthy competition among IM providers.

Nor does there exist a legal basis for continued imposition of the Condition. AOL's share of IM has fallen more rapidly than did AT&T's long-distance share during the period preceding the Commission's determination that AT&T was non-dominant.<sup>3</sup> The ability of consumers today to defeat an attempted price increase by easily shifting to established, branded, powerful rivals – such as Microsoft and Yahoo! – is no longer an untested theoretical possibility in a virtually new service offering, but a time-tested fact that confirms the lack of dominance by AOL. Plus, there is no indication that AOL's rivals lack the readily available excess capacity to constrain any attempt by AOL to exercise "dominance" in IM.

Finally, there is no economic basis for continued imposition of the Condition. This was ably demonstrated in the Affidavit of Professor William P. Rogerson, attached to the Petition. Professor Rogerson found there is clear and convincing evidence of strong competition in IM today and no longer any plausible reason to conclude that AOL is dominant or that IM has "tipped" or is likely to "tip" to AOL. Professor Rogerson noted the importance of more than two and a half years of data indicating that AOL's share of IM users has continued to decline while the shares of its primary competitors – Microsoft and Yahoo! – have continued to grow. A substantial historical record therefore exists for the Commission to assess the strength and direction of growth in competition in IM, and the record shows that competition is strong and

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<sup>3</sup> See Petition at pp. 12-17.

growing stronger. Moreover, where regulations such as the Condition no longer serve an evident pro-competitive purpose, they likely impose costs that are passed on to consumers in the form of reduced choice or decreased innovation in the market. For these reasons, the Condition is “no longer necessary in the public interest, convenience, and necessity” and must be lifted.<sup>4</sup>

We note that the only comments filed in response to the Petition, by Professor Gerald R. Faulhaber and Professor David J. Farber (“Faulhaber Comments”), addressed Professor Rogerson’s Affidavit. Professor Rogerson reviews these comments in his Reply Affidavit, attached hereto. One point made in the Faulhaber Comments, however, can be dispensed with readily here. Specifically, the Faulhaber Comments claim that AOL’s failure to interoperate is a “strategic decision . . . which only makes sense [for a firm] when its market presence is strong enough to cause tipping.” If that is true, however, both Microsoft and Yahoo! must believe *their own* “market presence” is strong enough to cause tipping – since they also have each chosen not to interoperate. If all three leading IM providers believe the market is so competitive, there is clearly no longer any basis for continuing to regulate AOL.

Simply stated, Professors Faulhaber and Farber continue to make the same arguments that were advanced in support of the Condition almost *three years ago*, ignoring the dramatically large amounts of new data that have become available in the meantime. Microsoft and Yahoo! clearly have robust user bases, and AOL has not been a barrier of any sort to the development of new IM-based services. Plainly, multiple strong competitors in IM are here to stay. For all of these reasons, there is no significant danger of IM “tipping” to AOL. Moreover, there are substantial costs to keeping the Condition in place, and the Faulhaber Comments do not provide

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<sup>4</sup> Order at ¶ 195. *Accord Fox Television Stations v. FCC*, 280 F.3d 1027, 1043-44 (D.C. Cir. 2001); *modified*, 293 F.3d 537 (D.C. Cir. 2002) (holding that Commission’s retention of a rule that could not be justified as “necessary in the public interest” was arbitrary and capricious).

any justification for continuing to impose those costs on consumers. Having failed to refute AOL Time Warner's showing that AOL is not "dominant" in IM or why IM is in any danger of "tipping" – and unable to justify the costs of continued regulation – the Faulhaber Comments do not make a persuasive case against granting the requested relief.

## CONCLUSION

AOL Time Warner has provided clear and convincing evidence of materially changed circumstances supporting the removal of the Condition. IM has not evolved as the Commission predicted. Today, there is no basis to conclude that AOL's IM offerings are "dominant." AOL's competitors are growing and innovating on their own. AOL's share of IM is declining. AOL does not control any input essential to competition and innovation in these services. The only purpose served by continuing to restrict AOL from offering video streaming AIHS is to chill competition, thereby reducing consumer welfare. For these reasons, the IM condition is not "necessary in the public interest" and the obligations on AOL Time Warner set forth in paragraphs 325-328 of the *Order* must be lifted.

Respectfully,

A handwritten signature in cursive script, reading "Steven Teplitz", is positioned above a horizontal line.

Steven N. Teplitz  
Vice President and Associate General Counsel  
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800 Connecticut Avenue, NW  
Suite 200  
Washington, DC 20006  
(202) 530-7883

Dated: May 20, 2003

**Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, DC 20554**

In the Matter of:	)	
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Applications for Consent to the Transfer	)	
of Control of Licenses and Section 214	)	CS Docket No. 00-30
Authorizations by Time Warner Inc. and	)	
America Online, Inc. Transferors, to	)	
AOL Time Warner Inc., Transferee	)	

**REPLY AFFIDAVIT OF PROFESSOR WILLIAM P. ROGERSON**

My name is William P. Rogerson. On April 2, 2003 I filed an Affidavit in support of the Petition of AOL Time Warner Inc. for the removal of the condition that restricts its ability to offer Internet users streaming video advanced Instant Messaging-based high-speed services ("AIHS") via AOL Time Warner broadband facilities (the "Condition").<sup>1</sup> I have been asked to respond at this time to the comments made by Professors Gerald R. Faulhaber and David J. Farber regarding my Affidavit.

**INTRODUCTION AND OVERVIEW**

The disagreements between Professors Faulhaber and Farber and myself seem to center on our different answers to two questions, so I will begin by explicitly posing the two questions on which we disagree.

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<sup>1</sup> *Memorandum Opinion and Order In the Matter of Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations by Time Warner Inc. and America Online, Inc., Transferors, to AOL Time Warner, Inc., Transferee, Memorandum Opinion and Order*, 16 FCC Rcd 2400 (2001) (hereinafter "*Order*").

*Question #1: Is there still a significant probability that the IM market will tip to AOL if it does not interoperate with its competitors?*

*Question #2: Should the Commission maintain the Condition even if it concludes that there is no significant probability that the IM market will tip to AOL?*

Briefly, Professors Faulhaber's and Farber's answer to both questions is "yes" and my answer to both questions is "no."

I believe that the Commission's decision in this matter should hinge on whether or not the Commission determines that there is still a significant probability that the IM market<sup>2</sup> will tip to AOL if AOL's IM services are not interoperable with its competitors. If the Commission concludes that there is no longer a significant probability that the market will tip, the Commission should remove the condition. If the Commission concludes that there still is a significant probability that the market will tip, the Commission should maintain the Condition.

The rationale for my position is that a regulation mandating interoperability is likely to be costly to enforce, induce inefficiencies and distortions of its own, and weaken incentives for innovation. If the Condition is necessary to preserve competition in this market, I believe that its benefits may well outweigh these costs. However, if vigorous competition will occur without regulatory intervention, the potential benefits of that regulation are much smaller while the costs remain equally high.

I believe the Commission originally adopted the Condition because it found, based on the record at the time, there was a significant danger that the market had or would tip to AOL in the absence of the Condition and we would be left with no competition in the market for IM

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<sup>2</sup> As I stated in my Affidavit, whether NPD-based services constitute a relevant antitrust market is a question that need not be addressed in the context of determining whether the restriction on AOL Time Warner should be lifted. For purposes of this analysis, I assume *arguendo* these services may be considered a relevant market.

services. If subsequent events have shown that this is no longer a danger, then the rationale for the Condition no longer exists and it follows that the Condition should be removed.

As I explained in my Affidavit, I believe that patterns, trends and levels of market share data from the over two-year period since the Commission issued its Order -- together with other events that have transpired during this period -- provide clear and compelling evidence that there are now three strong stable IM competitors and there is no longer any significant probability that the market will tip to AOL. Therefore it follows immediately that there is no longer any need for the Condition.

Professors Faulhaber and Farber initially argue that there is still a significant probability that the market will tip to AOL. This conclusion simply disregards the evidence that has become available in the last two years since the Commission originally made its decision.

I interpret the professors as offering a second line of argument as well. Namely, they seem to argue that, even if the market is in no danger of tipping to AOL, the Condition still produces net social benefits and the Commission should therefore maintain it. As I stated above, I believe that this would be a bad policy because the benefits that such a regulation could produce would be vastly smaller but all of its costs would remain as large. Furthermore, I believe that the professors are essentially asking the Commission to adopt a completely new rationale for the Condition by making this argument.

My paper is organized as follows. Section I explains in summary form why, as I explained in greater detail in my Affidavit, I believe there is clear and compelling evidence that there are now three strong and stable competitors in this market and there is no danger of tipping. Section II explains why I believe that it would be an inappropriate policy decision for the

Commission to decide to maintain the regulation if it concludes that there is no significant danger that the market will tip to AOL. Finally, I draw a brief conclusion.

**I. THERE IS NO LONGER A SIGNIFICANT PROBABILITY THAT THE MARKET WILL TIP**

The data show that there are two strong and stable competitors to AOL and there is no longer any significant probability that the market will tip to AOL. The professors' claims to the contrary are simply not supported by any facts. The professors' concerns about the absence of interoperability in this market likewise is not credible evidence either that AOL believes that the market is likely to tip or that anyone else should conclude that the market is likely to tip.

**A. What The New Data Show**

Based on my analysis of the data on market shares and other events that have transpired in the market since the Condition was enacted, I concluded in my Affidavit that there are now two strong and stable competitors to AOL in this market, viz. that the market is no longer in any significant danger of tipping to AOL. The professors agree that the new evidence "suggests that Microsoft and Yahoo! are indeed stable competitors" but state that the evidence is "merely suggestive" and does not constitute "clear and compelling evidence."

My own view is that the professors are maintaining the same arguments they made two and a half years ago without regard to the more recent data that has become available. At the time the FCC originally reviewed the AOL-Time Warner merger, it may have been reasonable to conclude that the market for IM services was still so new and so little data was available that predictions of future market shares could not confidently be made based on past market shares. In particular, even though at the time of the merger AOL had been losing market share to its two competitors over a few months, perhaps it could have been argued that the apparent growth in

competition was only temporary. Perhaps because firms were just forming their strategies and consumers were just learning about IM services, Microsoft and Yahoo! (who appeared to be providing strong competition to AOL at the time) might have faded as significant competitors. Perhaps the market was still so new that consumers were simply experimenting with different products but they would ultimately all choose AOL as the professors predicted. Perhaps Microsoft and Yahoo! were only “testing the waters” to see if they could compete with AOL and were on the verge of leaving the market.

However, we now have over two years of additional history to look at, and these speculations have not proven to be correct. Over this period AOL’s share of IM has continued to decline while its competitors’ shares have continued to increase. The question is not whether the changes have been dramatic or whether AOL continues to be larger than either of its competitors. The consistent and inexorable declining trend in AOL’s share supports my conclusion that the market is relatively stable and mature and that there is now clear and compelling evidence that there are three stable strong competitors in this market.

It is possible to argue that the market is about to reverse itself and tip towards AOL regardless of how long trends in the other direction have existed. It may have been reasonable and prudent for the Commission and the professors (who were on the Commission staff at that time) to be cautious about extrapolating historic trends during the merger review because Microsoft! and Yahoo had only recently entered the market and only a few months of data was available. However, after observing over two and a half additional years of stable trends, I think that it is unrealistic for the professors to posit that the trend may soon reverse and that AOL will drive its two main competitors (Microsoft and Yahoo!) out of business. By the standards of economic evidence that the Commission normally has available to it when it makes decisions, I

conclude that the Commission now has clear and compelling evidence that there are three strong stable competitors in this market.

**B. AOL's Failure To Interoperate Does Not Prove That AOL Believes The Market Will Tip**

Professors Faulhaber and Farber assert that AOL's failure to interoperate with its competitors "proves" that AOL believes that it can tip the market by "refusing" to interoperate with its competitors:

Denying interoperability is a strategic decision of a firm, which only makes sense when its market presence is strong enough to cause tipping, thus increasing its long run profits at the expense of its own customers. Professor Rogerson is silent on this point; if AOL Time Warner really hasn't tipped the IM market, then their optimal strategy is to interoperate, and yet they refuse to do so.

The fact that AOL does not interoperate with Microsoft and Yahoo! does not provide any independent credible evidence either that AOL believes that the market is likely to tip or that, anyone else should conclude that the market is likely to tip. The professors' "proof" that a refusal to interoperate on the part of AOL demonstrates that AOL believes the market will tip consists simply of their announcement that they can think of no other reason why a profit maximizing firm would refuse to interoperate with its competitors if it knew the market would not tip.

Allow me to supply such a reason. As I explained in my Affidavit, and as I discuss below in Section II, it is clear that entering into agreements with other firms to adhere to standards that allow interoperability might create significant costs for a firm. I listed four such classes of costs in my Affidavit.

- (i) Agreeing to standards can constrain an individual firm's design choices and ability to offer new products and features;

- (ii) Adjudicating disputes over agreements can be costly and time-consuming (regardless of “who” adjudicates);
- (iii) Competitors can attempt to game the standards to gain strategic advantages; and
- (iv) Once a firm agrees to standards that allow interoperability, it is likely that it will be much less able to benefit from the gains of new innovations it introduces.

Therefore a firm planning on “out-innovating” its opponents might be particularly unwilling to enter into an interoperability agreement.

There are many competitive industries with network effects where not all firms decide to make their products perfectly compatible with the products of all other firms because some combination of the above four classes of costs makes it prohibitively costly to do so.<sup>3</sup> As I argued in my Affidavit, all of these costs are likely to be significant for the case of the IM market. Therefore, I do not necessarily find it surprising that firms in the IM market have thus far decided not to interoperate with one another.

I would like to stress the point that it is not simply AOL that apparently views the costs of interoperability as being high. Microsoft and Yahoo! have not reached any agreement to interoperate with one another either. In the theory spun by Professors Faulhaber and Farber,

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<sup>3</sup> The example I offered in my Affidavit was word processing software. Professors Faulhaber and Farber assert that network effects are insignificant in the market for word-processing software because converters exist which allow files in one program to be translated to files in another program. However, such converters are imperfect at best and various special formatting features do not translate well. Furthermore, there are many other examples of relatively competitive markets where there are network effects but not all firms choose to be completely compatible with all other firms, and government does not pass regulations mandating compatibility. These include video game systems (the same software cannot be used on multiple systems), satellite TV (the same receiving dish and other equipment cannot be used for different services), various other types of computer software such as spreadsheet programs, data bases, accounting and record-keeping software, memory for digital cameras (different manufacturers use different, incompatible, data storage methods), and 35 mm cameras (a lens from one manufacturer cannot be used interchangeably with a camera body from another manufacturer).

where network effects are enormous and the costs of agreeing to compatibility are trivial, we would certainly have expected Microsoft and Yahoo! to agree to interoperate with one another to defend against the “aggression” of AOL. However, this has not happened.

## **II. THE CONDITION SHOULD BE REMOVED IF MULTIPLE STRONG COMPETITORS WILL SURVIVE WITHOUT IT**

As I stated in my original Affidavit, in any market with network effects, there is always a theoretical gain to be had from making all products compatible with one another if there were no costs to doing so. After all, if everything else is held constant, making all products compatible simply expands the size of everyone’s network and therefore makes everyone better off. The point I attempted to make was that there are *generally significant costs* associated with such regulation. This is why regulators as a rule do not mandate compatibility in markets that seem to be relatively competitive even if not all firms are making their products compatible with all other firms.

I described four different classes of costs of such regulations. In their comments Professors Faulhaber and Farber only chose to comment explicitly on the first three classes of costs that I listed. In particular, they apparently chose not to address the fourth class of costs I listed -- the diminished incentives for innovation. I will now briefly restate these four different classes of costs, and in the three instances where Professors Faulhaber and Farber had attempted to argue that these costs are not important for the case of IM, I will explain the flaws in their arguments.

#### **A. Standards Can Constrain An Individual Firm's Design Choices**

Professors Faulhaber and Farber suggest that some standards that firms have adopted related to internet interconnection appear to have worked quite well in the sense that they specified fairly minimal requirements and left firms free to exercise considerable freedom of design choice. My main comment here is that the vast bulk of these standards were voluntarily adopted by firms. I do not necessarily find it that surprising that firms that voluntarily enter into an agreement all end up benefiting from it. The question here is whether or not firms would be better off entering into an agreement that they apparently do not want to enter into. The fact that standards have worked well in some cases where firms have voluntarily adopted them does not, to my mind, provide very much evidence regarding whether a mandated standard imposed by government (or one effectively "forced" on a party as would be the case here) when firms themselves are unwilling to adopt it would also necessarily have the same benefits.

#### **B. It Is Extremely Costly To Develop Standards And Adjudicate Disputes**

Professors Faulhaber and Farber suggest that "Should it be necessary, adjudication should occur through the courts (or perhaps arbitration), a process that appears to work throughout the rest of the economy." I gather that their references to the way that courts and regulatory tribunals currently work are meant to quell my fears that disputes will be messy, costly, and ongoing. I gain no such assurances from my own understanding of the costs and inefficiencies that arise when parties use our current court system to settle regulatory disputes.

I note also that Professors Faulhaber and Farber were silent on my observation that imposition of mandated interconnection might well require the standard setting authority to begin to address the thorny issue of what price should be charged for interconnection.

### **C. Firms Would Game The Standard-Setting System**

Professors Faulhaber and Farber offer the observation that they believe that firms might establish a non-governmental authority to administer and set standards. I think this is possible. In fact, I specifically suggest this possibility in my Affidavit.

However, I do not think that the identity of the party that writes an agreement will necessarily affect whether or not the agreement can be strategically manipulated once it is entered into. The example I referred to in my Affidavit was the case where one party attempted to introduce a new service that, while valued by its customers, interfered in some ways with full interoperability. I predicted that, depending on the nature of the agreement firms had reached to insure interoperability, it might easily be the case that introduction of such a new innovation could be construed as violating the interoperability agreement, and that competitors of the innovator would have every incentive to prevent the innovator from introducing an improved product if this would take customers away from them. This example did not depend on whether government had written the agreement or not.

### **D. Incentives For Innovation Would Be Reduced**

This is the class of costs that I described in my Affidavit as being perhaps the most important costs of all for the case of the IM market. This is also the class of costs that Professors Faulhaber and Farber chose not discuss in their comments.

Once a firm agrees to various standards that permit interoperability, it is highly likely that the firm will no longer be able to appropriate as large a share of the gains from any innovation that it introduces. This is true for at least two reasons. First, to the extent that accommodating the new innovation requires firms to adjust the agreed-upon standard, the innovator will be

forced to give up some of the rents from innovation in the negotiation process when it tries to convince its competitors to allow changes in the standard that would permit the innovation. Second, in the absence of interoperability, consumers can only take advantage of the new innovation by switching to the innovator's service. When there is interoperability, to the extent that an innovator has to make parts of the innovation available to all firms in order to preserve interoperability, customers will be able to take advantage of the innovation without switching to the innovator.

### III. CONCLUSION

There is clear and convincing evidence that there are now three strong stable competitors in the IM market and that the market is in no danger of tipping to AOL. Since the Condition is no longer needed to insure the existence of a stable competitive market, it should be removed.

I declare that the foregoing is true and correct:

  
William P. Rogerson

Dated:

May 19, 2003